<u>OUTLOOK FOR FINANCIAL MARKETS as at 16/9/2014</u>

I think one of the main determinants of how financial markets will perform on AVERAGE over the next couple of years will be influenced by what happens to interest rates (Australian and Global), which at present are very low by historical standards (almost everywhere). Consensus seems to be that interest rates are not likely to rise to any meaningful extent, if at all, until the second half of 2015 or later. However given their extremely low levels one would have to think that they will eventually rise and return to more normal levels at some stage in future. On its own this would be a negative for almost all investment markets (except for short term fixed interest, i.e. cash). Theoretically however, interest rates should start to rise once economic growth (and as a consequence the threat of inflation above central banks' targets) increases to higher levels. Higher rates of economic growth is generally a plus for growth assets such as shares and property. So if interest rates rise as a result of higher growth then the negative impact of increased interest rates is offset by higher profits from business and higher rents payable to property owners.

The exception to this is if inflation gets out of hand and interest rates are rapidly increased by bigger amounts. If this were to happen then almost all investment options would suffer. With all the extra money in circulation now due to Central Bank money printing (quantitative easing) we can't dismiss this scenario as a possibility, but we have had the quantitative easing with us for some time now and it hasn't happened because the "velocity" of the money supply is lower than before the GFC, people's expectations for inflation is lower and most economies have a fair bit of "spare capacity" i.e. underutilisation of their available resources (both physical and human).

From a different angle and as a counter to those who think share prices are too high due to rises over the last few years, I would just like to point out:

- Australian share prices are at the same level now (16/9/2014) that they were 11 months ago and the same level as in late 2006 (nearly 8 years ago) and 20% below where they were on 31/10/2007.

- US share prices are close to record highs but when looked at over the longer term their rate of increase equates to only 2.4% per annum over the last 15 years, barely keeping up with inflation.

- Japanese share prices are still lower than they were in 1987 (or 2000 and 2007 for that matter) and European share prices are about the same level they were 15 years ago.

The following is a table outlining my outlook <u>on AVERAGE</u> for financial markets under various interest rate scenarios. I stress AVERAGE because to obtain an AVERAGE there is a broad spread of alternatives that are both above and below the AVERAGE (some by considerable margins). As always I stress the need to remain diversified as we can't predict the future with certainty and I still believe the medium to long term (3 years +) outlook for investment returns across most investment categories is sound (7% to 11% per annum across a diversified portfolio of investments).

CURRENT HOLDINGS	INTEREST RATES UNCHANGED	SMALL INCREASES IN INTEREST RATES (Gradual 0%-2%)	LARGER INCREASES INTEREST RATES (Rapid 2%+)
CASH			
- Australian	2.5% to 3%	2.5% to 4.5%	5%+
FIXED INTEREST			
Governement Bonds (medium to long term)			
- Australian	Expensive	Avoid	No go zone
- Global	Expensive	Avoid	No go zone
- Emerging Markets	Some fair value	Slightly expensive	Expensive
Corporate Bonds, Hybrids, Structured Credit etc.			
- Australian	Fair value	Slightly expensive	Expensive
- Global	Some fair value	Slightly expensive	Expensive
SHARES			
- Australian	Fair value	Slightly expensive	Expensive
- Global	Fair value	Slightly expensive	Expensive
- Emerging Markets	Some cheap	Fair value	Expensive
PROPERTY			
- Australian Direct	Fair value	Slightly expensive	Expensive
- Australian Listed	Slightly expensive	Expensive	Avoid
- Global Listed	Slightly expensive	Expensive	Avoid
OTHER			
- Infrastructure	Fair value	Slightly expensive	Expensive
- Private Equity	Some Cheap	Fair value	Slightly expensive
- Managed Futures	Not applicable as they should be able to make money whether things are going up or down.		